CASTING THE REGULATORY NET OVER VIRTUAL ASSETS – NEW REGULATION IN HONG KONG FOR CRYPTO FUND MANAGERS, FUND DISTRIBUTORS AND TRADING PLATFORMS

02 November 2018 | Hong Kong
Legal Briefings – By William Hallatt, Hannah Cassidy and Michael KS Tan

Yesterday, the Securities and Futures Commission (SFC) published a statement (Statement), together with a press release, setting out its new regulatory framework for virtual assets (also known as cryptocurrencies, crypto-assets and digital tokens).

Ashley Alder, the CEO of the SFC, made clear in his speech during the Hong Kong FinTech Week that the SFC’s aim in setting up this framework is “to step up as much as we are able to protect investors who trade virtual assets”, in particular from the unique risks associated with a rapidly expanding industry.

The Statement was published in parallel with a circular on the expectations around the distribution of virtual asset funds and a circular on the content of the Statement.

In this briefing, we explore what this new regulatory framework looks like and its key components.

WHAT PROBLEM IS THE SFC TRYING TO SOLVE?
WHAT PROBLEM IS THE SFC TRYING TO SOLVE?

THE EXPLOSION OF CRYPTO
Together with security regulators around the world, the SFC has taken note of growing public interest in virtual assets. The industry has grown exponentially. Over 2,000 different digital tokens are currently traded around the world with substantial trading volumes and an estimated total market capitalisation of over US$200 billion. In particular, there is a growing demand for funds which invest in virtual assets.

RISKS TO INVESTORS
The primary concern with these developments relates to investor protection and the unique risks associated with virtual assets:
| Valuation, volatility and liquidity | • No intrinsic value – not backed by physical assets or guaranteed by the government and no generally accepted valuation principles  
• Volatile by nature – prices on the secondary market are driven by supply and demand and are short-term  
• Liquidity issues – liquidity pools for virtual assets can be small and fragmented |
| Accounting and auditing | • No agreed standards and practices among accounting professionals relating to existence and ownership or valuations |
| Cybersecurity and safe custody | • Clients’ assets stored in online hot wallets can be prone to hacking  
• Limited availability of qualified custodian solutions |
| Market integrity | • Nascent market which does not operate under recognised and transparent rules  
• Outages, market manipulation and abusive activities are not uncommon |
| Money laundering and terrorist financing | • Virtual assets are generally transacted or held on an anonymous basis  
• Fiat/crypto exchange platforms are inherently susceptible to higher risks of money laundering and terrorist financing |
| Conflicts of interest | • Virtual asset trading platform operators may act both as agents for customers as well as principal dealers trading their own book |
| Fraud | • Insufficient product due diligence may lead to virtual assets being used as a means to defraud investors |

THE EXISTING REGIME
The SFC is principally mandated to regulate “securities” and “futures contracts”. Where virtual assets fall under the definition of “securities” or “futures contracts”, these products and related activities are likely to fall within the SFC’s jurisdiction.

The problem is that many virtual assets do not fall within the meaning of either “securities” or “futures contracts”, and in fact, they are often purposely designed that way. This means that:

- these out of scope (OS) virtual assets will not fall within the SFC’s jurisdiction;
- the operators of platforms which only provide trading services for OS virtual assets also do not fall within the SFC’s jurisdiction; and
- managing funds solely investing in OS virtual assets does not fall within the SFC’s remit (note however that if the firm is a licensed corporation, they are currently required to notify the SFC if they intend to provide trading and asset management services involving crypto-assets (see circular dated 1 June 2018)).

Currently, certain activities relating to OS virtual assets are already within the SFC’s jurisdiction and firms engaged in such activities are required to be licensed by or registered with the SFC. This includes:

- distribution of funds which invest in OS virtual assets (requires a type 1 licence); and
- managing fund of funds where the underlying fund invests in OS virtual assets (requires a type 9 licence).

The new regulatory framework pushes the SFC’s jurisdiction to its limits in order to expand the scope of regulation over virtual assets as much as possible.
CRYPTO FUND MANAGERS AND DISTRIBUTORS OF CRYPTO FUNDS

WHO IS IN SCOPE?
The SFC is seeking to impose further regulatory requirements on firms that it currently regulates:

<table>
<thead>
<tr>
<th>Licensed or registered firms</th>
<th>Current activity subject to regulation</th>
<th>New activity subject to regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Firms holding a type 9 licence</strong> that manage portfolios that invest (solely or partially) in OS virtual assets with: (i) a stated investment objective to invest in virtual assets; or (ii) an intention to invest 10% or more of the gross asset value (GAV) of the portfolio in virtual assets (<strong>de minimus threshold</strong>)</td>
<td>Management of portfolios invested in securities and/or futures contracts</td>
<td>Management of portfolios invested in virtual assets</td>
</tr>
<tr>
<td><strong>Firms holding a type 1 licence</strong> that manage collective investment schemes solely investing in OS virtual assets and distribute the same in Hong Kong</td>
<td>Distribution of collective investment schemes solely investing in OS virtual assets</td>
<td>Management of collective investment schemes solely investing in OS virtual assets</td>
</tr>
</tbody>
</table>

LICENSING TERMS AND CONDITIONS
The SFC will regulate the management activities by imposing a set of **terms and conditions** as **licensing conditions**. The terms and conditions will cover requirements around the type of investors and disclosure to investors, safeguarding of assets, portfolio valuation, risk management, auditors and liquid capital. In particular, only **professional investors** will be allowed to invest into a portfolio invested in virtual assets (subject to the de minimis threshold). Further details about the terms and conditions can be found in Appendix 1 to the SFC’s **Statement**.

LICENSING PROCESS
The SFC will first seek to understand the firm’s business activities. If the firm appears to be capable of meeting the expected regulatory standards, the terms and conditions will be provided to the firm and the SFC will discuss and vary them with the firm in light of its business model so as to ensure that the terms and conditions proposed by the SFC are reasonable and appropriate.

Failure to agree to comply with the proposed terms and conditions by an applicant or existing licensed corporation will respectively lead to the licensing application being rejected or the inability to manage any virtual asset portfolios.

**CONCEPTUAL FRAMEWORK FOR CRYPTO TRADING PLATFORMS**

**CONCEPTUAL FRAMEWORK AND SANDBOX**

The SFC has also set out a conceptual framework for the potential regulation of virtual asset trading platforms. The SFC plans to work with interested virtual asset trading platform operators that have demonstrated a commitment to adhering to the high expected standards by placing them in the SFC Regulatory Sandbox. Further details of the conceptual framework are set out in Appendix 2 to the Statement.

For an operator to join the sandbox, it would need to fall within the jurisdiction of the SFC, and therefore it should:

- operate an online trading platform in Hong Kong;
- offer trading of at least one or more virtual assets which fall under the definition of “securities” on its platform; and
- provide for trading, clearing and settlement services for virtual assets and have control over investors’ assets.

**EXPLORATORY STAGE**

The SFC intends to discuss its expected regulatory standards with participants; observe the live operations of the trading platforms; and consider the effectiveness of the proposed regulatory requirements in addressing risks and providing adequate investor protection.
The aim of this information gathering exercise is to allow the SFC to be able to determine whether or not it is able to effectively regulate such trading platform operators. In order not to confuse the public about the regulatory status of platform operators, the identity of the sandbox applicants in this stage and the discussions will be kept confidential.

Of course, it remains possible that the SFC will conclude that the risks involved cannot be properly dealt with under the standards it would expect, and that investor protection still cannot be ensured.

**LICENSING AND INTENSIVE REVIEW STAGE**

If on the other hand the SFC decides that operators are suitable for regulation, this is likely to lead to the imposition of standards comparable to those applicable to existing licensed providers of automated trading services. A licence by the SFC would give a trading platform a clear competitive advantage over its unlicensed peers. It will act as an indicator to the market and investors that the operator is willing to adhere to a high level of standards and practices.

Where the SFC grants a licence to an operator, licensing conditions would be imposed and the operator would proceed to the next stage of the sandbox. This might involve more frequent reporting, monitoring and reviews under the SFC’s supervision so that the platform operators can implement robust internal controls and address the SFC’s concerns arising from the conduct of their business.

**EXITING THE SANDBOX**

After a minimum 12-month period, the operator may apply to the SFC for removal or variation of some licensing conditions and exit the sandbox.

**CONCLUDING THOUGHTS – LEGITIMISATION THROUGH REGULATION**

There will be mixed reactions to the steps taken by the SFC. As noted by Ashley Alder, there will be “many in the Fintech world [who] see regulation as an unnecessary or unwelcome brake on innovation”. This is largely reflective of the efforts by those in the crypto industry, and in particular virtual asset issuers, that have sought to ensure that virtual assets do not fall within the scope of “securities” and “futures contracts”.

However, a large part of that same industry have been waiting patiently for the SFC to take affirmative steps to bring order to this expanding industry through regulation, as recognised by Ashley Alder, “[r]esponsible players in this industry also recognise that clear and effective regulation will be essential for them to establish the trust and legitimacy they need to make their businesses credible.”
This will no doubt include a substantial number of those targeted by the new regulatory framework who will likely welcome the SFC’s efforts to legitimise crypto through regulation.

**KEY CONTACTS**

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

**WILLIAM HALLATT**  
PARTNER, HEAD OF FINANCIAL SERVICES REGULATORY, ASIA, HONG KONG  
+852 21014036  
William.Hallatt@hsf.com

**HANNAH CASSIDY**  
PARTNER, HONG KONG  
+852 21014133  
Hannah.Cassidy@hsf.com

**MICHAEL TAN**  
SENIOR ASSOCIATE, HONG KONG  
+852 2101 4237  
Michael.Tan@hsf.com

**ARNOLD PUN**  
ASSOCIATE, HONG KONG  
+852 21014196  
arnold.pun@hsf.com

**LEGAL NOTICE**

The contents of this publication, current at the date of publication set out above, are for reference purposes only. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on this publication.

© Herbert Smith Freehills 2019